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CURRENCIES AND CREDIT MARKETS

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"On January 15, 1931, Harrison (President of the New York Fed) explained that the country had experienced the most drastic deflation of bank credit in history, and that the policy of the Federal Reserve System was not to stimulate inflation, but to halt deflation."

Charles Kindleberger, The World in Depression 1929-1939
p. 184, Penguin Press London

HIGHLIGHTS

World markets are coiled in anticipation of a sustained recovery in the U.S. and a number of other countries, while expecting a slowing European economy. Evidence we see suggests it couldn't be more different.

Most worrying in the U.S. is a virtual collapse in broad money growth (M2, M3 and M4). Though unprecedented in the post-war period, there is general zeal to explain it away as more or less irrelevant.

Our own investigations, as explained in this letter, lead to the opposite conclusion. The money crunch is a very serious matter because it reflects a worsening crunch on private credit.

Above all, precipitous declines in the prices of commercial real estate, which makes up a sizable chunk of the financial system's collateral, is eroding capital and liquidity.

Another important question is the monetary effects of the thrift bailout. Many consider it as a mere "bookkeeping" exercise. That, too, is grossly mistaken. It cuts the money supply and drives up long-term interest rates.

What are the ultimate causes of the money collapse? Our answer: A combination of a crowding-out and a credit crunch — the latter a function of both the demand and the supply side.

U.S. monetary growth is far too low to alleviate the devastating real estate crisis and to permit any kind of sustained economic recovery. Considering all the aggravating financial woes, we venture to say that the U.S. economy has entered its most dangerous period since the Great Depression.

The U.S. bond market faces its most adverse supply/demand condition ever. A ballooning budget deficit coincides with sharply lower private savings and capital inflows. The savings necessary to absorb the current deluge of bonds are simply not there.

The greatest oddity in this picture is the buoyant U.S. stock market. It can't last.

In conclusion, we reflect on the differences in the international situation between today and the 1930s.

WAITING FOR GODOT

After a time of relative quiet — at least since the failed Russian coup — markets are all poised for major moves . . . to the upside everyone thinks, of course. Expectations for the dollar and markets worldwide have been buoyed by legions of forecasts cooing the message that the recession-economies — importantly the U.S. — are on the verge of a sustained recovery.

Without a doubt, the question of whether or not there will be a sustained recovery in the U.S. and the other recession economies is the pivotal element underpinning market expectations. It's exactly that point, though, that keeps us so worried. Why and what's our point of focus? U.S. money and credit is mired in a protracted and progressive weakness which has caught most experts, including the Fed, by surprise. The fact that not too many are convinced that its something to worry about probably explains the present calm of markets . . . before the storm.

The growth rate of M2 has fallen off sharply from an annualized 6.4% between January and April of this year to just 0.7% since then. The M3 growth rate for the two periods, respectively, has fallen from an annualized 4.4% to a negative 2.1%. Worst of all has been the performance of M4 (or L), which, in addition to M3, includes savings bonds, short-term treasuries, bankers' acceptances and commercial paper held outside of financial intermediaries. M4 has grown 1.1% against a year ago but has dropped $25 billion between March and June this year. In real inflation-adjusted terms, these figures speak of a drastic contraction. **In fact, such a contraction has not occurred since the 1930s.** Irrelevant? Hardly.

TRAIL OF THE MONEY CRUNCH

To start, at issue are two key questions: Why is money and credit growth not responding to the Fed's drastic easing measures and what are the implications of such sluggish money and credit growth for the real economy?

Wall Street has been quick to provide happy answers to the second answer while skipping the analysis of the first. The most prevalent and comforting notion is that low monetary growth is more likely to reduce inflation than GNP growth (read: good for corporate earnings and financial valuations). But, the facts just don't measure up. As of mid-1989, when economic growth peaked, exactly the opposite has been occurring. Ever since, inflation has proved more resilient that GNP output.

Another anaesthetized interpretation of the weak monetary aggregates is that they mainly reflect portfolio shifts due to sharply uneven interest-rate declines. Since bank deposit rates have fallen faster than the yields of intermediate- and long-term securities, the view is that investors have shifted from low-yielding bank and S&L deposits, which are counted in the money supply, into higher-yielding assets which are not. Such a shift, it is argued, does not matter for the real economy even though it depresses monetary growth.

No doubt, such a shift has taken place at a large scale, particularly into bond and equity funds which aren't part of the money aggregates. However, what's left out of the account, is the fact that such an asset shift is the regular pattern of all recessions. Yet, never before has it happened in the context of a pronounced and protracted monetary sluggishness.

In order to appreciate the present abnormalities one has to first know what the normal behaviour of money is before a recovery ensues. The chain of developments starts with easier money pushing down short-term interest rates. The steepening yield curve acts as a powerful force, driving investors and corporate borrowers into bonds and shares. Bond and stock prices soar and, in the process, contribute tremendous wealth effects to the consumer. This shift in corporate financing away from the banks to the security markets is a crucial element since the soaring issues of bonds and shares serve to strengthen corporate balance sheets.

Then, the second crucial element enters: Given slowing private credit demand and ample reserves, the banks rush to expand their holdings of government bonds and cause longer-term yields to fall. Although it is true that bank loan demand typically weakens during recessions, accelerating money growth is still assured by virtue of soaring bank investments, which, also help implement the necessary lowering of long-term interest rates.

Clearly, two things are abnormal today and demand explanation. During the 12 months preceding the previous five post-war recessions, the broad monetary aggregates grew at an average pace of around 7%. That compares dismally to rates of 2.5% for M2, 1.6% for M3, and 1.1% for M4 this time. The other abnormality is the sticky long-term interest rate.

Why this unusual monetary weakness? In order to understand the monetary processes, it is essential to analyze credit and money flows together. Why? Because the obvious cause behind this exceptional money crunch is a gathering credit crunch both inside and outside the banking system.

THE LINK TO THE THRIFT BAILOUT

One main actor in the credit crunch, despite the bailout operations, are the thrifts. After having e expanded their assets and liabilities by about $80 to 90 billion annually between 1985 and 1988, the thrifts have since shed about $250 billion, most of it having been near-money and part of the money stock. That's a lot of money by comparison when one realizes that M3 rose by $56 billion and M4 by only $66 billion in 1990. Yet, Wall Street economists and even the Fed seem to believe that money can't get lost; that other parts of the financial system must be soaking it up and putting it to work.
The prevailing view of the S&L bailout is that it represents nothing more than a "bookkeeping" exercise with no real-life affects on interest rates or the money supply. That couldn't be further from the truth. Yet, here are some official statements that endorse this line of reasoning:

The January 1991 Economic Budget Outlook of the Congressional Budget Office reads like this on page 73: "*Although financing the thrift bailout will add substantially to federal borrowing requirements in the next few years, this borrowing does not put much additional pressure on interest rates. The money that the government borrows to resolve insolvent thrifts and banks (less the administrative and interest costs) is returned to financial markets. The money is redeposited in new accounts or invested directly in income-earning assets.*"

Barron's of May 28, 1991, also catches Mr. Greenspan in the slipstream of the same logic. He is quoted as saying: "*While the size of the S&L crisis is 'astronomical', Federal Reserve Chairman, Alan Greenspan, contended that the overall effect of the increased financing on interest rates is 'moderate'. That's because the bailout borrowings don't represent any new credit; Uncle sam's liabilities are*

substituted for those of the busted thrifts."

Well, those may be cosy notions, however, a brief dissection of the sequence of effects that are involved in the bailout operations reveals otherwise. The starting point, of course, is found at the thrifts and the banks that have suffered huge losses on their assets and collateral values. These losses necessarily imply corresponding losses for stockholders and depositors. Essentially, their money has vanished.

Next, the government decides to take over the losses of the depositors. Actually, what it does is to replace the vanished deposits. But whence do the hundreds of billions of dollars come from with which the government pays off these depositors? Does the money rain from the sky? Is it a product of the legendary printing press? Not at all. The government borrows the money in the markets, and in doing so, essentially drains these funds from the existing pool of liquid savings. The funds for the bailouts are withdrawn from other uses. The net effect, then, is a corresponding contraction in the overall money supply.

Ironically, bailing out the thrift depositors by borrowing the necessary funds from the markets has exactly the same contractionary effects on the money supply as the banking crisis of the 1930s when the Fed and the administration did nothing to rescue the depositors. What's worse, the rescue operation massively swells the supply of government bonds which tends to force up longer-term interest rates.

GOOD MONEY AFTER BAD

It's truly ludicrous to think that the bailout-related government borrowing is some kind of free lunch. This type of public borrowing is really comparable to the private-sector example of a corporation borrowing to finance its losses. The government is doing precisely that — borrowing to finance the losses incurred by the S&L's.

Keynes called this type of financing "distress" borrowing. Quoting him: *"The slump itself produces a new queue of 'distress' borrowers who have to raise money to meet their losses . . . The thing will never cure itself by the lack of borrowers forcing down the rate; for it absorbs just as much savings to finance losses as to finance investment."* The point to recognize is that savings spill over into losses . . . good money follows bad.

In one highly important aspect, Mr. Greenspan and all the others that belittle the implications of the thrift bailout are right. The pay-outs to the depositors of the busted thrifts have no stimulative effect on the real economy at all. Their great error is the conclusion that the whole operation therefore doesn't matter for interest rates and the money supply.

Summing it up: The new borrowing has no real stimulative impact, yet, at the same time, tends to force up interest rates and to contract the money supply. It's hard to imagine a fiscal/monetary mix that could be more restrictive.

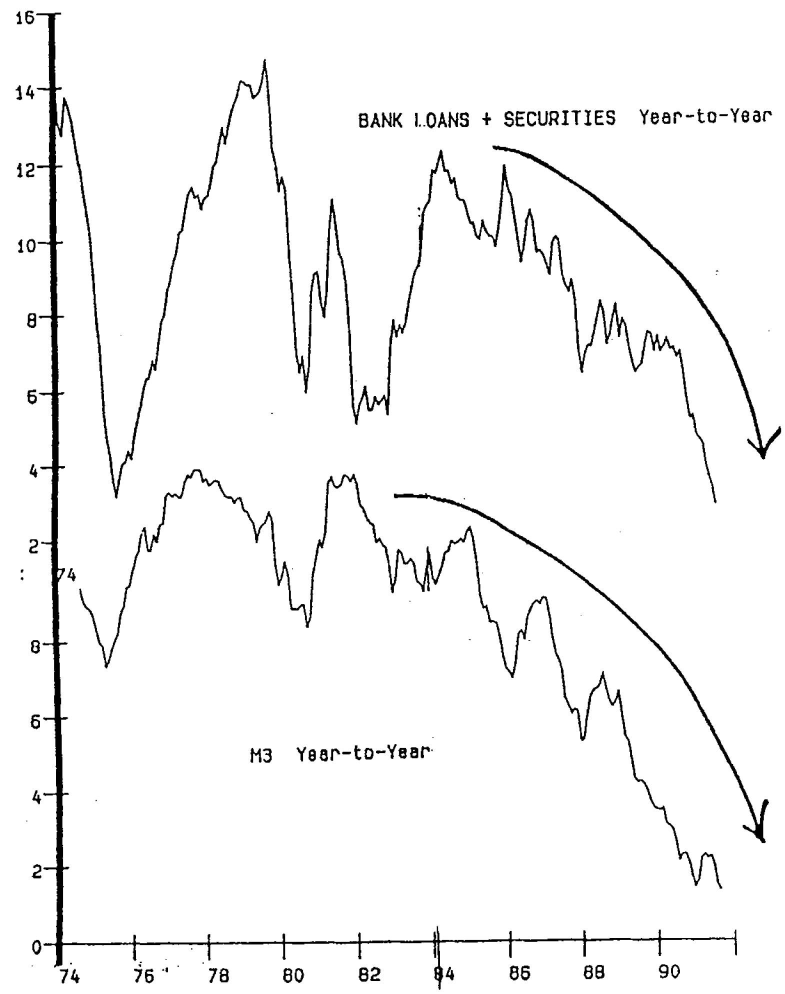
A CROWDING-OUT, TOO

The administration itself concedes that next year's fiscal deficit will hit $368 billion, of which $100 billion or more will be needed to fix the thrifts. That forecast, as pessimistic as it is, assumes a healthy

economic growth rate of 3%. In the event of an economic relapse and rising thrift and bank failures, the market may well have to finance a federal budget deficit of between $400-500 billion.

All of this must be considered against the background of an increasingly disastrous savings environment. The ballooning budget deficit coincides with declining household and corporate saving and, last but not least, a virtual desertion by foreign investors. In 1989, foreign net bond purchases amounted to $63 billion and last year fell to $20 billion. Given the generally higher bond yields abroad, it's hard to see any foreign interest in the U.S. bond market for the foreseeable future. Taken altogether, the U.S. bond market faces unprecedentedly adverse supply and demand conditions.

U.S: MONEY AND CREDIT TRENDS



Source: International Strategy and Investment

MONEY CRUNCH LINKED TO CREDIT DEMAND SLUMP

It goes without saying that the thrift bailout can only be a partial explanation of the protracted monetary weakness. Were it not for the burgeoning budget deficit, U.S. money supply would be collapsing. Although increased bank lending activity is the predominant avenue of expanding money supply, it's not the only way. During recessions, as already explained, banks regularly spur money and deposit creation by stepping up investments in government bonds.

During the first seven months of 1991, as might be expected in a recession, commercial banks have increased their bond holdings by $48 billion. What's new and unprecedented is that over the past few months this money creation through bond investments has been largely cancelled out by shrinking loans. At the end of July, total loans and securities at all commercial banks amounted to $2,758 billion as compared to $2,751 billion at the end of March.

Observing the decrease in bank loans, the massive deposit contraction at the thrifts, and a shrinking commercial paper market, it's immediately obvious what the overwhelming cause of the monetary sluggishness is — a virtual collapse of credit creation for the private sector. Year-over-year, private debt (business and consumer combined) has increased 3.4% which is by far the lowest growth rate of the whole post-war period. Government debt growth, on the other hand, is accelerating towards double-digit rates.

What's going on here is that soaring government borrowing is squeezing private credit demand out of the markets. The following table showing the relative development of government and private credit demand speaks for itself. In short, a crowding-out is being perpetuated at an unexampled scale. In effect, the Fed's aggressive monetary easing is being more than offset by sticky long-term interest rates and plunging business profits resulting in shrinking private credit and money supply and nipping any recovery in the bud.

UNITED STATES: TOTAL NET BORROWING
($U.S., Billions)

	1987	1988	1989	1990	1991 Q1
U.S. Government	144.9	157.5	151.6	272.5	55.8
Total Private	542.1	603.3	526.6	368.7	18.2

Source: Federal Reserve, Flow of Funds

In this last analysis, we've shown that any money creation in the United States is presently the result of new government debt being taken up by the banks. But why does the soaring budget deficit have so little stimulative effect on the real economy? In short, because apart from the crowding-out effects on private borrowing and spending, a rapidly growing portion of government spending and borrowing is unrelated to GNP. The two biggest expenditure items now are an annual interest bill of almost $200 billion and a thrift bailout of more than $100 billion.

The crowding-out is one side of the problem; the supply side of the credit crunch is another. If it's true that consumers and others may be reluctant to borrow, banks and other financial institutions have reasons to slow or halt their lending, too.

DECLINING COLLATERAL VALUES AGGRAVATE THE CREDIT CRUNCH

A new plague is sweeping across the whole U.S. financial system: precipitous declines in real estate prices which happen to make up a sizable chunk of loan collateral. As the values of collateral drops, capital is impaired and the ability of banks, thrifts and insurance companies to expand new loans becomes severely restricted.

As financial institutions, individuals and corporations scramble for liquidity, in the process dumping assets on an illiquid market, they progressively undercut each others values and solvency. Irving Fisher's famous textbook "debt deflation" is playing out in the real-life, nation-wide depression of real estate values, destroying capital, liquidity and money supply in its wake.

Considering the gigantic overhang of vacant commercial real estate, the real estate deflation is certainly only in its first phase. The salient point to see is, that over time, asset deflation will be transmitted to the whole of the real estate market as lease and rent renewals are adjusted to reflect the depressed prevailing market — just as the reverse happened on the upside during the asset inflation of the 1980s.

1930s REVISITED

Most observers, it appears, have yet to realize that the U.S. banking system of today is far more shaky than it was during the early 1930s. The most memorable statistic of that earlier crisis is that altogether more than 9,000 of some 30,000 banks crashed between the four years of 1930 through 1933. By that measure, it seems that about one-third of the banking establishment fell into the abyss.

Those statistics are deceptive, however. With one single, but infamous exception — the Bank of the United States in New York — the rest of the failed banks were comprised mostly of microscopic institutions in agricultural communities. Well over 60% of the crashes were among banks with capital of $25,000 or less and were located in towns of no more than 1,000 inhabitants. Overall, the total loss borne by depositors, stockholders and other creditors amounted to approximately $2.5 billion — depositors taking the brunt for roughly half representing hardly more than 3% of total bank and thrift deposits. By comparison, estimated stock market losses towered to about $85 billion over the same four years.

The larger banks, particularly the New York money-centre banks, weathered the storm with strong capital positions and extremely high liquidity. Citybank, for example, the predecessor to modern-day Citicorp, had a ratio of liquid assets to net deposits of 63% in 1929. Throughout the entire banking contraction, this ratio never fell below 59%. Banks then were roundly criticized for fear that their penchant for liquidity was preventing an economic recovery. Today, this liquidity ratio is often well below 30% for the big banks.

Another well-known fact of the 1930s is that a savage monetary contraction ensued. Between 1929 and 1933, banks deposits plunged by over 42% and money supply contracted by over one-third. Much less appreciated, though, is that this monetary collapse didn't start in earnest until March-April of 1931. From year-end 1928 to year-end 1929, broad money only declined from $55.5 billion to $54.9 billion. By March of 1931, broad money was only marginally lower at $53.8 billion. That was a pretty mild decline and much less than the coincident decline in the consumer price index. On that basis, even in the first Depression year, there was no decrease in the real supply of money. And, compared to the wholesale price index, the real money supply actually soared.

In their book, The Monetary History of the United States, Friedman and Schwartz admit that *"as a fraction of total wealth, the losses produced by bank failures were minor and would deserve no more attention than losses of a comparable amount in, say, real estate."* They then continue: *"If the bank failures deserve special attention, it is clearly because they were the mechanism through which the drastic decline in the stock of money was produced and because the stock of money plays an important role in economic developments."*

But in comparing the situation of 1990-91 with that of 1930-31 we note two conspicuous contrasts: In terms of real money growth, today's monetary conditions are more stringent than they were back then.

More vivid and sensational is the difference in the behaviour of the U.S. stock market. In 1929-30, it was the first to collapse while today it remains resolutely and stubbornly optimistic.

There can be no doubt as to what will be the most determinative influence over the longer run — virtually inescapably, it'll be the weakening money supply. All the same, the buoyant stock market may, as long as it lasts, provide a prop to confidence in general.

ARRESTING THE DOWNTURN

Wall Street likes to comfort itself with the idea that post-war recessions have lasted no longer than eleven months on average. On that basis the recession should already be over. It can't be overlooked, though, that all of these recessions have ended with an indispensable forerunner — a strong monetary expansion through the aegis of credit and money creation by the banking system. If that fails to materialize, a recovery is simply impossible.

The important question really is what has to happen to arrest and reverse this cumulative process of contraction. The short answer is that a rapid credit and money creation is required that would finance increased spending on both goods and assets. What's happening, though, is the opposite: a financial system in the midst of a capital squeeze, corporations witnessing the deepest profit squeeze in decades and the consumer immobilized by an income squeeze.

DECLINING MONEY SUPPLY MATTERS

Earlier, we asked what would be the implications of a prolonged sluggishness in money and credit. Inexorably, it implies a deepening asset price deflation and a deepening recession. Since the epicentre of this rumbling asset and credit deflation is a shaking real estate market, and since real estate has such a broad impact on money and credit flows, it's only a matter of time until this contractive force also hits the stock market with a vengeance.

Yet, Wall Street has a happy disposition to only take notice of things that support its rosy expectations. The one and only such thing that fits that optimism on the money side is M1, the narrowest of monetary aggregates which is presently growing at a strong clip of 8%.

There's a hitch inherent in the M1 numbers, though, that is being conveniently ignored. The rise in the quantity of M1 has been more than offset by its collapsing velocity of circulation. The total flow of money — in theoretical terms "MV", representing money times velocity — is therefore shrinking and indicates that the increases in M1 are not being spent on goods and services. If MV did not fall, there could and would be no recession. That's elemental arithmetic which doesn't need further statistical verification.

Many assert that the big spread between short and long-term interest rates is a sign of easy money which is sure to revive the economy sooner or later. Indeed, in the past, it always has, but it overlooks the true cause of the current spread. Long rates have remained sticky due to the government's soaring budget deficit while short-rates have plunged. Long rates have been kept excessively high during a time of low business profitability. The normal effect of declining short-term interest rates on bond yields this time is being impeded by the heavy supply of government bonds resulting in a "crowding out."

NO SAVINGS: MYSTERY BOND BUYERS

The savings necessary to absorb the current deluge of government bonds are simply not there. New private savings are running at $150-160 billion annually as compared to a budget deficit of more than $300 billion. From that perspective, U.S. long-term interest rates should rise over the longer run.

In the meantime, then, who is buying all of those bonds? As already mentioned, the commercial banks are big buyers. But there's an even bigger buyer operating in the background. That's the securities brokers and dealers who are arbitraging out huge profits by borrowing short in the repo-market and employing the funds in the longer-term, higher-yielding bond markets.

Dealer purchases of bonds amounted to $90 billion in 1989 and an additional $37 billion last year. During the first quarter of 1991, when a economic recovery was expected they turned into heavy sellers acting to depress the market. We would guess that dealers are back again as big buyers, now that economic recovery prospects are evaporating. That's probably one of the main sources of the recent bond market rally — massive interest rate speculation based on the repo-market. Needless to say, any prospect of a monetary tightening, for whatever reason, would quickly prick this bubble, thus boosting long-term interest rates and nipping any recovery in the bud.

DECOY AND CONFIDENCE PROP: THE STOCK MARKET

While a resilient U.S. stock market is of little economic significance, its persistent peppiness has played a key role in fostering the perception of an economy that's basically strong and healthy. A sliding stock market, though, would quickly deal a shattering blow to confidence.

Could it happen . . . another stock market drop, we mean? Considering the grim picture of the trends in money, credit, business profits, real estate and available savings, there's little question that the stock market strength stands out as an flagrant oddity. Compared to a year ago, the average price-earnings ratio has soared from 12.2X to 23.3X for the Dow Jones Industrial stocks and from 14.8X to 21.6X for the component S&P 500 stocks. The average earnings/yield (the inverse of the price/earnings ratio) for the Dow Jones Industrial stocks has slumped from 8.20% to 4.29& and for the S&P 500 from 6.74% to 4.63%.

Just think of some of the things that have happened in these past 12 months; a period during which stocks prices have skyrocketed in terms of the price-earnings ratio by some 60-80%. A thrift and banking crisis has loomed, a real estate crisis ravaging capital and liquidity, broadly shrinking real money, a virtual doubling of the federal deficit, and a savage profit and income squeeze.

But, Wall Street looks away and boasts of the stock market's perfect record of forecasting recession-ends and the onset of economic recoveries during the past 70 years. Stock market wisdom, of course, is a modest circumscription for Wall Street wisdom.

CONTINENTAL EUROPE VERSUS THE UNITED STATES

Presently, it's a favourite view among American and British economists that Germany, through its combination of high interest rates and a sharply weakening domestic economy, is dragging Europe into

recession while the U.S. economy is on the mend. The London-based Economist captured the sentiment best with the following headline: "*Will Germany Tow Europe into Trouble?*"

While Germany is supposedly ailing, its GNP is up 4.8% against a year ago. In contrast, U.S. GNP has only risen 0.8% over the same period. Retail sales volumes are up 13.2% in Germany; they're down 2.1% in the United States. At the same time, the demand burst associated with German unification has turned the economy into Europe's locomotive as Germany has showered the rest of its European neighbours with export orders — the extent of this stimulus being reflected by the abrupt decline in its current account surplus. According to official estimates, 0.8 percentage points of the European Community's expected growth rate of 1.4% in 1991 is accounted for by the effects of German unification. Without the unification, more European countries would be in or on the brink of a recession.

It's only arithmetically logical that the initial East-German demand boost will eventually taper down into lower trends in current income and output. But this passing of the bulge represents nothing more than a normalization — certainly not a recession. Automobile sales, for example, are up 53% (yes, fifty three percent) in Germany between January and July; they're down 25% in Britain. We can already imagine the newspaper headlines if German auto sales start to stagnate at this high level and British sales hopefully rise 10% — Germany Sinks Into Recession, Britain Booms? Even if GNP were to stand still in the second half of 1991, year-over-year GNP growth would still amount to 3%.

LONGER RANGE GLOBAL ECONOMIC OUTLOOK IS PIVOTAL

In our view, the hectic and near-sighted discussions about the next quarter's GNP growth in various countries isn't worth the candle. What's more important at this juncture is not the current growth rate but, rather, what will play out over the next few years. From that perspective — in contrast to the prevailing view, we might add — we think Europe will be the source positive surprise whereas North America will show negative ones. Why?

Clearly, there is a widespread prejudice evident. Pessimism is being consistently directed at Europe and Germany and only optimism towards North America. Typically, growth projections for Germany have erred on the low side over the past few years, while being far too high for the United States.

Since the end of 1987, domestic demand has grown a cumulative 15% in Germany, 13% in the European Economic Community (EEC) and only 5.2% in the United States. The EEC figures also include the Britain, which has been mired in a long recession.

Just how fast will the European economies grow the next and following years? How fast will North America power out of its slump? Without a doubt, these are the key questions for markets. The answers have far-ranging implications for currencies, interest rates, inflation and employment.

Comparing the two continents, the first thing to realize is that the U.S. and Canadian recessions are purely domestically-driven. Strong foreign demand has so far ameliorated the downturn. In contrast, the economic weakening in the European Community (EC) is mainly driven externally. Here, contracting demand in the U.K., other Anglo-Saxon and Scandinavian countries are the negative influence.

GLOBAL EFFECTS OF THE U.S. SLOWDOWN

The international situation today is diametrically different from that of the 1930s. Then, the United States absolutely dominated the world both in trade and finance — the latter, above all, as the world's greatest lender. In contrast, Europe was financially vulnerable and economically weak. As it was, Germany collapsed immediately when U.S. capital outflows dried up.

Today, America is vulnerable and weak while Europe is economically and financially stronger than ever before. As already explained, the U.S. bank and S&L failures of our time are just as bad or worse in relative terms than the banking collapses of the 1930s. Even more ominous than the similarities on the part of the United States, are the differences. After the World War I, America emerged as the world's leading creditor nation. Today, it is a country heavily indebted to foreigners. Today, on top of it all, America is dealing with a serious and unprecedented budget crisis.

In the 1930s, America drew the whole world into the Depression because it abruptly cut both its imports and its foreign lending. Today, the world is more financially independent of America. In fact, to the contrary, America today is dependent on foreign capital.

Moreover, American markets have lost some of their importance to Europe's foreign trade. In 1989, the United States only accounted for 5.9% of EC country exports as compared to a much higher 7.9% in 1958.

THE LULL BEFORE THE STORM

No doubt, a deepening U.S. recession will adversely impact economic growth in the rest of the world. But U.S. trade is only marginal for Europe. In 1989, U.S.-bound exports only accounted for 5.9% of the EC countries' total. The United States imports little more from Europe than from Canada.

What the world *does* have to fear from the U.S., however, are the potential world-wide repercussions of a financial crisis. That, essentially, would entail a currency crisis.

In the meantime, both the dollar and the stock markets worldwide have been buoyed by legions of forecasts that the recession-economies — importantly the U.S. — are on the verge of a sustained recovery. Whether there will be such a recovery is the most important question for everyone — policy-makers, markets, investors, and people in general. In the play, Godot never arrives, and that's the end. If so, however, what would happen?

How will the central banks of countries either in recession or on the brink of recession respond if their own economy and that of the rest of the world proves much weaker than expected? The major critical points in this scene would be the United States, Canada, Australia, Britain, France and Italy. For the time being, markets hail each new easing as a necessary and desirable step towards recovery. There may well come a time, though, where easing measures will be seen as a sign of weakness and desperate policies.

It's easy for any government and central bank to stick to a policy of stable exchange rates and tight money as long as it doesn't risk spreading a recession. That acid-test for these policies will come when

the policy requirements for stable exchange rates begin to clash very harshly with those for growth and employment. Not all governments and central banks will be able to stand the pressure.

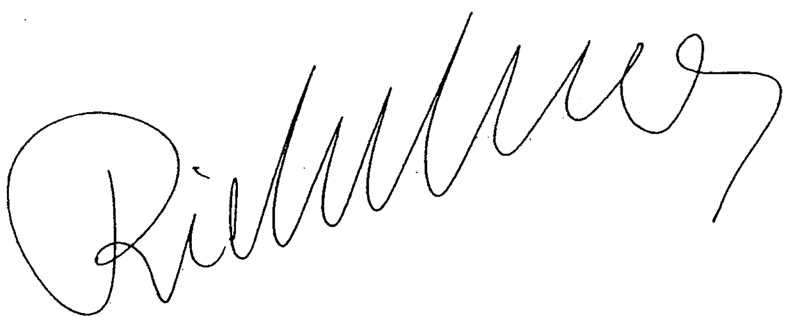
SUMMARY CONCLUSIONS

The more we study the U.S. monetary, financial and economic fundamentals, the more we are convinced that the U.S. economy is locked in a recessionary environment . . . in fact, a long-term downtrend.

Summing it all up: U.S. monetary growth is far too low to alleviate the devastating real estate crisis and to permit any kind of sustained economic recovery. Considering all the aggravating financial woes, we venture to say that the U.S. economy has entered its most dangerous period since the Great Depression.

What are the chief factors underlying our negative assessment? No less than unanimous fundamental indications of the quartet of money, credit, business profits and income growth. Although officials in Washington and an army of economists may continue to promise that better times are just around the corner, the hard truth is that all four recovery fundamentals are progressively deteriorating.

All in all, taking into account the many adverse factors — a crowding-out, a contractive bailout, a credit and monetary crunch — the nonchalance of markets and experts just boggles the senses. There's the strong prospect of an accident just waiting to happen.



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